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# Construction

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A NEWSLETTER FOR THE CONSTRUCTION INDUSTRY

SPRING 2010

## Succession Planning Time to Plan a Graceful Exit?

It appears that genuine recovery is still some time away for much of the construction industry. Nevertheless, it's not too soon to start looking ahead at what's next.

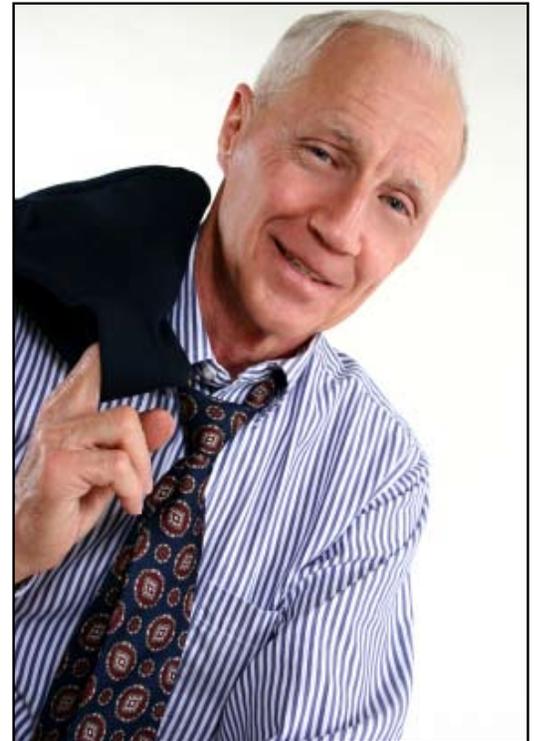
For some contractors, that means looking for a way to exit the company once business improves. The challenge they face is finding a way to step away without sacrificing the value they've built.

There's never a bad time to review your company's succession plan — or to create one if it doesn't exist — but in some ways now is an especially good time to do so. Beyond the psychological and emotional reasons that may lead you to consider an exit, there are also sound financial and strategic opportunities that can be realized by taking advantage of the current economic downturn.

### ESTATE PLANNING ISSUES

Your business' succession plan and your personal estate plan are closely related — or at least they should be. Unfortunately, estate planning is often an afterthought for business owners.

Many contractors may not even realize they could have estate tax issues because they don't realize the full value of their companies. Even though your business's value has almost certainly dropped in recent years, and even though there may not be a ready market for selling it today, a contracting business with a successful history, sound reputation and strong management team can nevertheless have significant net worth in book value alone.



This matters now, in particular, because the current downturn may present a valuable opportunity to reduce the owner's estate — and thus reduce the estate's potential tax liability. If you are a business owner who wants to pass on your family-run business to the next generation, the company's current lower value could allow you to transfer a larger portion of the business' stock to family members.

When the company grows again in a few years, that taxable value will have been removed from your estate. So if your business forms the bulk of your estate, moving some or all of the company out of your estate now could result in significant estate tax savings in the future.

# When Should Income Be Reported?

How does your company report taxable income for partially completed work? That might seem to be a highly technical — even arcane — question, but the answer could have a significant impact on your tax liability.

Failure to understand the tax implications of your income reporting method could lead to a large and unexpected tax bill — which is likely to come due when you can least afford it.

## “PERCENTAGE OF COMPLETION” VS. “COMPLETED CONTRACT”

Most large contractors (generally speaking, those with annual gross receipts of \$10 million or more) are required to use the “percentage-of-completion” method for reporting income on long-term contracts that span more than a single tax year.

“Using this method, income from the contract is reported in each tax period according to the percentage of costs that were incurred during that period compared to the estimated total cost of the contract,” says Vito Loisi, Partner, Wolf & Company LLP.

On the other hand, most small contractors are permitted to use other accounting methods for reporting income; in particular, the “completed contract” method is frequently used. Under this method, all contract revenue is deferred until the contract is completed.

The ability to defer reporting income for tax purposes until the job is completed is obviously appealing, but the completed contract method can cause confusion, especially related to the definition of the term “complete.” A contract is considered complete for tax purposes upon final acceptance by the owner. The IRS defines this as the time when the customer actually begins using the product of the contract and

when at least 95 percent of the total contract costs have been incurred. IRS rules specify that minor unfinished punch list work or the lack of a final certificate of completion is not adequate reason to declare a project incomplete for tax reporting purposes. Neither is unreleased retainage or lack of payment.

## POTENTIAL PROBLEMS AND CONCERNS

While the completed contract method may allow you to postpone the income tax liability for a long-term project, this can be a double-edged sword. For example:

- When several contracts are completed during a single reporting period, the completed contract method may result in your company having to report a substantial spike in income for tax purposes.
- Unless management exercises strong financial discipline, it is easy to spend cash from early billings. Then, when the income is finally reported for tax purposes, there may not be sufficient funds to meet the tax obligation.
- A deferred tax obligation can be particularly dangerous during a prolonged downturn, as the industry is experiencing now. When cash flow is greatly reduced, a large tax liability for work that was done in a prior year could threaten the company’s survival.
- In most instances, alternative minimum tax (AMT) must be calculated using the percentage-of-completion method instead of the completed contract method. Unfortunately, this can partially offset the interim tax savings that might be achieved using the completed contract method.

Determining which income reporting method to use for tax purposes can be a complicated decision, and there are

costs incurred in switching methods. Under certain circumstances, however, a change in method could provide an interim benefit that could help your business survive a challenging economy. ■

*To discuss how we can help you determine the best method for reporting income for your business call Vito Loisi at 630-545-4554.*

## Succession Planning

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It could also save you money in the near-term. For example, if you envision using the proceeds of a life insurance policy to cover estate taxes (a popular estate planning feature), removing a large portion of the estate’s value now could allow you to purchase a much smaller policy.

## ENSURING CONTINUITY

Of course, passing a business on to family members is only one of many possible exit strategies. While selling the business outright to a competitor or to outside investors may not be a likely option these days, now could be a good time to consider transferring partial or total ownership to a trusted subordinate or internal management team.

Obviously, in such a scenario you won’t pass on ownership as an outright gift as you might with family members. But today’s reduced valuation of the company could make it more feasible for a management team to put together enough funds to acquire at least partial ownership, allowing you to begin relinquishing day-to-day operational control while still retaining an interest in the business. Another important aspect of succession planning is developing a continuity plan to address what would happen in the event of your death or disability. One well-

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## Joint Ventures

### Look Before You Leap



A joint venture can be a valuable tool that may help your company qualify for a sought-after contract, expand into new geographic markets, or enter into a new segment of the industry. But while a joint venture can open new doors, there are also risks and potential pitfalls. Here are some key points to consider:

**1) Understand the rationale for the joint venture.** Each party must bring something to the table that the other needs, such as knowledge, skills, geographic presence, political influence, or the ability to meet

specific qualifications. Small construction companies may band together to compete with giants, or large companies may form alliances with quicker and nimbler small businesses.

**2) Analyze each member's strengths and weaknesses.** Each party should complement the other's attributes. For example, one company might possess needed technical expertise, while the

other knows the local market or the project owner. Structure the venture to take advantage of each party's strong suit.

**3) Choose your partner carefully.** Evaluate your respective management styles and determine how to collaborate without stepping on each other's toes. Also, be sure there's mutual trust. If you are worried the other company might not act ethically, stop negotiations immediately.

**4) Formalize it.** Have your attorney draft a formal joint venture agree-

ment that spells out every detail of the relationship. This includes financing, management and decision-making procedures, methods for protecting the participants' interests, and procedures for resolving conflicts.

**5) Define the procedures for wrapping up the joint venture at the outset.** Typically, one partner buys out the other or an outside party buys the entire entity. You could also take the joint venture public or recapitalize it through private investors.

Joel Dzedzic, Partner, Wolf & Company, LLP says, "Partnering with another contractor to share resources, strengths, know-how or opportunities could be very beneficial, but a successful joint venture requires careful planning and an atmosphere of mutual trust and respect." ■

*Our firm can help you analyze the financial and strategic aspects of a proposed joint venture. For more information call Joel Dzedzic at 630-545-4508.*

## Succession Planning *Continued from page 2*

established approach is a buy-sell agreement that names certain key managers as successors, and provides a means for them to finance the purchase from your estate through installment payments, outside financing, life insurance proceeds or some other means.

### SENDING A SIGNAL

A valuable additional benefit of succession planning is the signal it sends to other interested parties, including lenders and sureties. A concern for bonding companies is what will happen if the company loses key personnel, especially the owner. Having a succession plan in place tells the surety you're planning for the long-term health of the business. This can be an especially important

confidence-builder when owners are approaching retirement. In the same way, a succession plan tells lenders, competitors and, above all, potential customers that you are a well-established and reputable business, and are prepared to move quickly when growth opportunities reappear — as they inevitably will.

### THE NEXT STEP

So how should you get started in planning your exit? Begin by assembling a team — including your accountant, lawyer, estate planner and other key advisors — who can help you define your goals. A professional valuation will also be an important early step, since any plan must be based on accurate, reliable data. In addition, a valuation might

uncover other useful information regarding your position in the market, potential risks, and current industry and market trends. Although your primary concern these days might be simply hanging on through the current business cycle, it's never a bad time to plan for your company's long-term future — and your own. With qualified professional help, you can use today's challenging business environment as an opportunity to lay a foundation for renewed growth. ■

*Let us help you put together an effective succession planning team. Call our office to discuss in detail how we can help or check out our white paper, "Build Your Construction Company Exit Strategy" on our website at [www.wolffinancialgroup.com/Construction-and-Real-Estate](http://www.wolffinancialgroup.com/Construction-and-Real-Estate).*

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## Construction Briefs

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### FASB's "Going Concern" Standard Could Affect Your Business

A pending change to the Financial Accounting Standards Board (FASB) reporting standards could have a serious impact on many construction companies' ability to obtain financing, maintain lines of credit or even qualify for future contracts.

The change being considered would broaden the conditions under which "going concern" issues must be disclosed on a company's financial statements.

The term "going concern" describes a company that has the resources needed to continue operating. The existing FASB standard requires management (and accounting

professionals) to disclose whenever there is substantial doubt about an entity's ability to continue as a going concern for a period of 12 months beyond the date of the financial statements.

The proposed revision would remove that "bright line" 12-month standard and replace it with a requirement that management consider the company's prospects for a period that is "at least, but not limited to" 12 months beyond the end of the reporting period.

Formal adoption of the new standard has been delayed while the FASB considers ways to clarify the language so it does not require

an indefinite look forward. Even as these concerns are being addressed, however, it is clear that the new standard could raise going concern issues for some contractors.

A going concern notation on the financial statements not only would affect a company's ability to obtain new financing, it could also cause the business to be considered out of compliance with the covenants on an existing line of credit. To shore up your creditworthiness, consider raising additional capital, selling idle assets, delaying expenditures, or bringing in additional ownership to expand your company's available resources. ■